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Internal Revenue Service
memorandum

CC:TL:Br1
LJFernandez

date: JUN 24 1986

to: District Counsel, Seattle CC:SEA
Attn: Henry Thomas Schafer

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your memorandum dated April 3, 1986, requesting technical advice with respect to the above-captioned case.

ISSUE

Whether a seller-lessee is entitled to depreciation and interest deductions as a result of a real estate sale-leaseback transaction.

CONCLUSION

We believe the purchaser-lessor is entitled to those deductions attendant to ownership of the property. Our primary argument is that the Danielson Rule applies. Alternatively, the presence of a business purpose on the part of the purchaser-lessor, the use of recourse financing, and the possibility of substantial appreciation and cash flow inuring to the benefit of the purchaser-lessor indicate that the purchaser-lessor has the benefits and burdens of ownership. Although we would prefer to have the purchaser-lessor's case consolidated with the instant one for trial, we believe that the facts of this case leave us no alternative but to recommend litigation.

FACTS

The facts discussed below were compiled through an analysis of those documents originally submitted with the request for technical advice, documents submitted on June 10 and 11, 1986, and telephone conversations with a representative of your office. We note that some of the facts are unclear and contradictory. We also note that the discovery process has not been completed, and that the final facts may vary from those presented below. However, for purposes of our analysis we have relied on the subsequent discussion.

Prior to [redacted], [redacted] owned real estate in [redacted] upon which it wished to construct an apple processing and shipping facility. To this end, [redacted] entered into a sale-leasback transaction structured by [redacted]. 1/ Pursuant to this transaction, [redacted] sold the real estate to [redacted], a single purpose financing corporation controlled by [redacted], for approximately $[redacted]. [redacted] apparently secured financing for the facility with the assistance of [redacted] and built the facility to [redacted]'s specifications. [redacted] then leased the facility back to [redacted] on [redacted], pursuant to a net lease.

Under the [redacted] lease, [redacted] could use the premises for an interim term beginning [redacted], until [redacted] and a primary term commencing on [redacted], until [redacted]. Thereafter, [redacted] had the right to extend the lease for [redacted] consecutive terms of [redacted] years each. It is not clear whether the rent that was payable over the term of that lease is sufficient to amortize the loan and provide a profit. Pursuant to paragraph 13, [redacted] had the right to make additions and alterations to the premises and, pursuant to paragraph 32, could require reimbursement from the purchaser-lessor.

Paragraph 17 provided that [redacted] could make an irrevocable offer to purchase the premises for a formula price set forth in Schedule C of the lease (which appears to track the amortization of the loan) should [redacted] determine that the premises had become uneconomic and unsuitable for [redacted]'s continued use. Paragraph 33 provided [redacted] the right to purchase the premises at the end of the primary term at the same formula price. In the event of purchase by [redacted] under any of the provisions of the [redacted] lease, paragraph 22(a) required the lessor to pay off the notes and deliver the premises to [redacted] free of the mortgage lien.

[redacted]

In [redacted], [redacted] sold [redacted], along with other strawparty corporations, to [redacted], a California limited partnership. The general partners were [redacted] and [redacted]. The sole limited partner was [redacted]. At the time of the purchase of [redacted], [redacted] assumed a mortgage balance with respect to the [redacted] facility of approximately $[redacted].

In [redacted], [redacted] became the debtor in a Chapter XI bankruptcy proceeding. Pursuant to approval of the Bankruptcy Court, [redacted] and [redacted] assigned their interests in [redacted] to [redacted] on [redacted]. Subsequently, [redacted] executed deeds to transfer the properties from [redacted] to [redacted] as tenants in common.

In [redacted], [redacted] decided to expand the leased premises and expended approximately $[redacted] to do so. [redacted] then invoked paragraph 32 to require reimbursement from the purchaser-lessor. As part of a transaction to acquire funds for the reimbursement, [redacted] formed [redacted], and transferred the property to such corporation. [redacted] then issued promissory notes to two insurance companies to obtain financing. The notes have substantial balloon payments upon maturity and appear to be fully recourse as to [redacted]. 2/ Subsequently, the property was deeded back to the [redacted] subject to the amended lease described below.

In order to reflect the [redacted] transaction, the lease was amended on [redacted]. Most of the provisions of the [redacted], lease remain effective with only minor amendments, *e.g.*, the primary term was extended to [redacted]. However, paragraphs 32 and 33 of the [redacted] lease were deleted in their entirety and replaced with a new paragraph 32 concerning [redacted]'s irrevocable offer to purchase the premises. Under revised paragraph 32, if [redacted] had not purchased the premises prior to [redacted], [redacted] on that date will be deemed to have made an irrevocable offer to purchase, on [redacted], at a price equal to the greater of: (1) the fair market value of the premises encumbered by the lease as if all options for the extended terms had been exercised, and (2) the price as determined under Schedule C (as amended to reflect the reimbursed cost of the expanded facilities). Paragraph 22(a) continues to require the purchaser-lessor to pay off the mortgage if the offer to purchase is accepted.

2/ See footnote 10 for a brief discussion of the liability of the [redacted].

Pursuant to the amended lease, the rent was increased to account for the cost of the improvements. The rent for the 20 year primary term under the amended lease appears to be approximately $[redacted] per year in excess of the note amortization payments.

You indicated that for the [redacted], [redacted], and [redacted] tax years, both the purchaser-lessor and the seller-lessee were taking those deductions that were attendant to ownership of the property. You also state that, because a statutory notice has not yet been issued to the [redacted] and because you cannot request another continuance, it is unlikely that this case can be consolidated with the [redacted] case for trial.

ANALYSIS

In construing the terms of a contract to determine the tax consequences properly resulting therefrom, the court must decide to what extent the specific terms of the agreement will be given literal effect. If the terms of the contract are clear and unambiguous, the Commissioner reserves the right to bind the parties to those terms unless proof is adduced, that would be admissable in an action between the parties to the agreement, to show unenforceability because of mistake, undue influence, fraud, or duress. This is the rule of Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

The real estate sale-leaseback arrangement discussed above appears to have been negotiated at arms-length. The [redacted] lease and the amended lease are clear and unambiguous. Therefore, we recommend that the Danielson Rule be applied to [redacted] and that the primary argument be that [redacted], having chosen to structure the transaction as a lease arrangement, is bound to accept the tax consequences flowing therefrom. This recommendation is consistent with a Litigation Guideline Memorandum dated October 18, 1985, concerning "Utilization of the Danielson Rule." As stated in the Litigation Guideline Memorandum, the Danielson Rule is to be argued irrespective of the expected posture of the Tax Court towards Danielson.

The Danielson Rule has been rejected by the Tax Court which prefers the "strong proof" rule, i.e., when parties to a transaction have specifically set out their agreements in clear terms, strong proof must be adduced to overcome that declaration. Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), aff'g. 29 T.C. 129 (1957). However, under the doctrine of Golsen v. Commissioner, 54 T.C. 742 (1970), the Tax Court will follow a United States Court of Appeals decision which is squarely on point where appeal from the Tax Court decision would lie in that particular circuit.

[redacted]'s primary place of business appears to be [redacted]. See, the statutory notice of deficiency. Therefore, venue would properly lie in the Eighth Circuit. I.R.C. § 7842(b)(1)(B). Based upon Sullivan v. U.S., 363 F.2d 724 (8th Cir. 1966), it should be argued that the Golsen Doctrine mandates application of the Danielson Rule. Although Sullivan was decided prior to Danielson, the court refused to allow the taxpayer to vary the tax consequences resulting from an unambiguous contract. Moreover, although not citing Danielson, the Eighth Circuit has reaffirmed Sullivan. See St. Louis Union Trust Co. v. U.S., 617 F.2d 1293, 1300 (8th Cir. 1980).

Should [redacted]'s primary place of business prove to be [redacted], venue will lie in the Ninth Circuit. Although the Court of Appeals for the Ninth Circuit is an advocate of the "strong proof" rule, such court has indicated that it might apply a stricter standard more akin to the Danielson Rule. See Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977). See also Ehlert v. Commissioner, T.C.M. 1985-479, n.6. Therefore, we believe that arguing the applicability of the Danielson Rule is appropriate should venue lie in the Ninth Circuit. 3/

Should the Tax Court determine that the Danielson Rule is not applicable, we recommend, as an alternative, that you argue that the substance of the transaction indicates that the purchaser-lessor is the owner of the property for federal tax purposes. A discussion of this alternative argument follows.

With regard to real estate sale-leaseback transactions, the Internal Revenue Service has, generally, challenged the deductions and credits taken by the purchaser-lessor on the grounds that such party is not the true owner of the subject property for federal tax purposes. 4/ This approach has been based on a conclusion the purchaser-lessor did not acquire the benefits and burdens of ownership.

3/ The recommendation of arguing the Danielson Rule assumes that [redacted]'s case is not consolidated with that of the purchaser-lessor. If the cases are consolidated for trial, we wish to be informed so that we may reconsider the applicability of the Danielson Rule.

4/ In Helvering v. Lazarus & Co., 308 U.S. 252 (1939), the government challenged the deductions of a seller-lessee on the since reputed grounds that ownership for federal tax purposes followed legal title. The Supreme Court rejected this contention. Henceforth, the Service has generally challenged the deductions of the purchaser-lessor given the presence of facts evidencing a sham or financing arrangement.

The benefits and burdens of ownership argument is based upon the Tax Court's holding in Estate of Franklin v. Commissioner, 544 F.2d 1945 (9th Cir. 1976), aff'g. 64 T.C. 752. That case concerned a purported real estate sale-leaseback arrangement in which a non-recourse loan was used to pay a greatly inflated purchase price. The Service successfully argued that the purchaser was not entitled to interest or depreciation deductions because, rather than purchasing the property, the partnership merely acquired an option to purchase the property in the future. The Tax Court noted that the stated purchase price bore no relation to fair market value, nor did it appear that the sales agreement transferred any of the benefits and burdens of ownership.

The instant case is a departure from those real estate sale-leaseback transactions previously litigated by the Service because here it is the seller-lessee who wishes to use the principles developed in case law to secure depreciation and interest deductions notwithstanding that the transaction was structured as a leasing arrangement.

The landmark case in the real estate sale-leaseback area is Frank Lyon Co. v. United States, 435 U.S. 561 (1978). In that case, a bank wished to construct a new headquarters building but could not finance the construction itself because of certain regulatory requirements. Therefore, the bank entered into a sale-leaseback arrangement with Lyon whereby the bank leased the real estate to Lyon, and sold the building to Lyon as it was constructed. Lyon then leased the building to the bank on a net lease basis. Pursuant to the financing arrangement, Lyon was primarily liable on the mortgage notes made to finance construction.

Under the terms of the building lease, the annual rent was equal to the annual principal and interest payable by Lyon on the mortgage notes. Further, the bank had the option to repurchase at certain times during the lease term at a price equal to the unpaid balance of the permanent lender's mortgage, plus Lyon's $500,000 investment, plus 6 percent interest compounded on that investment.

In determining that Lyon was the owner of the building for federal tax purposes, the Supreme Court focused on the economic substance of the transaction and considered several factors including: (1) the bank had a business (regulatory) purpose for structuring the transaction as it did, (2) Lyon was not a corporation with no purpose other than to hold title to the bank building, (3) Lyon's capital was committed to the building and Lyon was primarily liable for the construction loans and permanent financing, (4) the transaction involved three parties, the bank, Lyon, and the financing agency, (5) the bank could "walk away" from the lease at the end of the primary term, 5/ and (6) the reasonableness of the rentals and the substantialty of the purchase price.

In establishing a test for analyzing real estate sale-leaseback transactions, the Supreme Court stated:

> In short, we hold that where, as here, there is a multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. [435 U.S. at 583-584]

In Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd, per curiam, 671 F.2d 316 (9th Cir. 1982), cert. denied, 459 U.S. 907 (1982), the Tax Court applied the test as articulated by the Supreme Court in Frank Lyon and broke such test down into its integral parts. The Court indicated that a real estate sale-leaseback arrangement would be upheld if such transaction (1) is genuinely multiple-party, (2) with economic substance, (3) completed or encouraged by business realities (no "regulatory" realities were claimed in Hilton), and (4) imbued with tax independent considerations which are not shaped solely by tax avoidance features. Hilton, supra at 347.

The Court concluded that the petitioners (purchasers-lessors) failed the Frank Lyon test because the sale-leaseback transaction lacked economic substance and, consequently, had no substantial legal and economic significance apart from tax considerations. Specifically, the low rental and nominal cash flow aspects of the arrangement convinced the Court that the value of the petitioners' interest was substantially less than the amount paid for such interest. Such economic analysis rejected the speculative possibility that the property would have a residual value at such time, if ever, the lessee abandoned the lease. Further, the Court applied the "Prudent Abandonment" Test of Estate of Franklin, supra, in determining that the petitioners would not at any time find it imprudent from an economic point of view to abandon the property. Hilton, supra at 360.

5/ In this regard, the Supreme Court noted that if the bank did not exercise its option to extend the building lease, Lyon could do what it wished with the building. This possibility, the Supreme Court stated, brought into sharp focus the fact that Lyon, in a very practical sense, was at least the ultimate owner of the building. Frank Lyon, supra at 567, n.3.

In distinguishing the transaction before it from that considered in Frank Lyon, the Court made the following observations:

(1) The rent paid under the building lease in Frank Lyon was sufficient to amortize 100 percent of the mortgage principle. In Hilton, the rent would amortize only 90 percent of the mortgage principle leaving a sizable "balloon" at the end.

(2) The rent in Frank Lyon was set at fair rental value. In Hilton, the rent was not based upon fair rental value. Further, after the initial lease term in Frank Lyon the rent provided positive cash flow. In Hilton, the rent was relatively insignificant and if applied to amortize the refinanced "balloon" would provide insignificant, or no, cash flow.

(3) In Frank Lyon, the purchaser-lessor invested $500,000 of its own funds in purchasing the building. In Hilton, none of the petitioners' funds were invested.

(4) In Frank Lyon, the purchaser-lessor could realize a substantial gain if the seller-lessee exercised its repurchase option. In Hilton, the petitioners could not dispose of the property at a profit.

(5) In Frank Lyon, the purchaser-lessor was a substantial business entity that participated in the negotiation of the sale-leaseback arrangement. In Hilton, the entire "deal" was packaged as a financing arrangement and marketed as a tax shelter. 6/

The Court also noted that while the absence of personal liability of the petitioners was a neutral factor, the fact that the purchaser-lessor in Frank Lyon was personally liable on the mortgage notes was a significant factor supporting the bona fides of the sale-leaseback transaction in that case.

An additional factor that weighed against petitioners in analyzing the prospects of economic gain was that the seller-lessee could exercise its right to purchase the interest of the purchaser-lessor in the premises, subject to the nonrecourse debt, at a fixed price, should the purchaser-lessor receive a bona fide offer to purchase and decide to accept such offer. Therefore, if the offered price exceeded the option price, the seller-lessee would merely exercise its option and pocket the gain. Hilton, supra at 357.

6/ The Court regarded this factor as a further indication that the arrangement was not "a genuine multiparty transaction" when taken in concert with the other factors present. The Court noted, however, that this factor alone was not necessarily fatal.

In the more recent case of Sanderson v. Commissioner, T.C.M. 1985-447, the Tax Court upheld the validity of a real estate sale-leaseback transaction. Sanderson concerned a transaction between J. C. Penney, as seller-lessee, and Penn-East, a limited partnership, as purchaser-lessor. Penn-East leased the land and purchased the buildings thereon, and leased the buildings back to J. C. Penney on a net lease basis. Subsequent to such transaction, Penn-East transferred its interest in the building, and assigned its interest in the land lease to Penn-Centennial, a limited partnership. Penn-Centennial then marketed limited partnership interests to potential investors. Penn-Centennial financed the acquisition by executing a nonrecourse promissory note payable to Penn-East with a substantial "balloon" upon maturity.

The petitioners in Sanderson were limited partners in Penn-Centennial whose claimed share of partnership losses were disallowed, inter alia, on the grounds that the sale-leaseback transaction was a sham and should be disregarded for federal tax purposes because it lacked economic substance, or was a financing arrangement rather than a sale.

Pursuant to the net lease, the rental payments closely approximated the principle and interest payments required under the mortgage notes (assumed by Penn-Centennial from Penn-East). If J. C. Penney determined that its operation of the buildings as retail stores was uneconomic, it had the right to terminate the lease and offer to purchase the building at a fixed price which was calculated to approximate the unamortized balance and accrued interest at any given time on the outstanding mortgage loans. If this offer were refused, Penn-Centennial was entitled to lease the buildings to a third party at the then fair market value.

Beginning on a fixed date that was within the initial term of the lease, J. C. Penny had an option to purchase the buildings at a price equal to the greater of the then fair market value, or the fixed price described above. If J .C. Penney did not extend the term of the net lease upon the expiration of the initial term, and the mortgage loans were still outstanding, Penn-Centennial could request J. C. Penney to purchase the buildings at the fixed price described above.

Finally, Penn-Centennial had the right to sell, transfer, or assign at any time its interest in the property. This right was subject to J. C. Penney's approval which could not unreasonably be withheld. However, J. C. Penney had a right of first refusal to buy the buildings upon the same terms contained in any third party offer.

In analyzing the facts, the Court relied on Estate of Thomas v. Commissioner, 84 T.C. 412 (1985), and Rice's Toyata World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd. in part and rev'd in part on another issue, 752 F.2d 89 (4th Cir. 1985), two computer equipment leasing cases, to interpret the Frank

Lyon test. The Court interpreted the test to mean that for the validity of a sale-leaseback transaction to be upheld, the transaction must satisfy a subjective "business purpose" test or an objective "economic substance" test.

After applying the test, the Court concluded that the sale-leaseback arrangement had economic substance and was a valid transaction. 7/ The Court reasoned that the investment in the buildings provided a realistic opportunity for economic profit apart from tax benefits given, inter alia, that the buildings were located in an area where values had been increasing at a significant rate. Further, because the Court concluded that the purchase price paid by Penn-Centennial did not exceed the buildings' fair market value, the Court rejected the Service's reliance on the "Prudent Abandonment" Test to show that Penn-Centennial would be able to abandon the equity. Relying on Hilton, supra, and Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev'd on another issue, 670 F.2d 785 (8th Cir. 1982), the Court also rejected respondent's following contentions offered to support a finding of a sham or financing arrangement: (1) the rental payments were sent by the seller-lessee to an independent trustee instead of directly to the purchaser-lessor, (2) insignificant cash flow was generated from the transaction because the rental payments closely approximated the principal and interest payments required under the mortgage notes, and (3) the purchaser-lessor was not liable on the outstanding mortgage notes.

In the wake of the cases discussed above, and others, the Service's litigation position is to deny deductions to a purchaser-lessor if any of the following arguments can be made: 8/ First, a valid sale did not take place in which the purchaser-lessor acquired the benefits and burdens of ownership. In this regard, if the parties fail to respect the structure of their transactions, the validity of the underlying sale is subject to question. Shaefer v. Commissioner, T.C.M. 1980-440; Sanborn v. Commissioner, T.C.M. 1983-579. Second, the indebtedness incurred by the purchaser-lessor so greatly exceeded the fair market value at the outset of the transaction that the indebtedeness is not bona fide. Estate of Franklin, supra. Third, the transaction was a sham or a mere financing arrangement.

7/ The Court found it unnecessary to find a business purpose given the fact that the transaction possessed economic substance, but nevertheless indicated that the fact that a petitioner who was knowledgeable about business and real estate transactions who believed his investment would result in current cash flow and long-term appreciation, had a business purpose. See Sanderson, supra, n.11.

8/ These arguments are not intended to be exclusive, but appear to be most relevant to the real estate sale-leaseback arrangement described in the documents submitted with your request for technical advice.

With regard to the third argument, Sanderson is particularly damaging in proceeding against purchasers-lessors in its use of the business purpose and economic substance tests as alternative tests. Although the economic substance test presents the opportunity to provide detailed analyses of cash flow and appreciation projections 9/, the business purpose test is usually easily met in the real estate arena as was previously discussed at footnote 6.

A corollary to the foregoing discussion is that if a real estate sale-leaseback transaction is not subject to attack on any of the grounds discussed above it is likely valid. If it possesses the characteristics of a bona fide transaction pointed out by the courts in the cases discussed above, then the purchaser-lessor is likely entitled to the deductions that are attendant to ownership of the property.

The instant case contains several factors present in Frank Lyon and Sanderson that were pointed out by the Courts as supporting a valid transaction. First, the arrangement is genuinely multi-party with the insurance companies providing financing 10/. Second, the business purpose of [redacted] is similar to that of the investors in Sanderson, i.e., the documents submitted by you on June 12, 1986, indicate that [redacted] is knowledgeable about business and real estate transactions and believed his investment would realize long-term appreciation. Third, the use of recourse financing indicates an investment by the purchaser-lessor and a bona fide arrangement. 11/

9/ If such analysis reflects a positive cash flow and/or reasonable prospect of economic gain the sale-leaseback transaction is likely to be upheld. Sanderson, supra.

10/ For this reason, we would attack [redacted]'s reliance on Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), in the same manner as did the Supreme court in Frank Lyon and the Tax Court in Sanderson, i.e., Sun Oil considered a two party transaction where one of the parties was an exempt trust.

11/ The notes appear to be fully recourse as to [redacted], and, because of the assumption agreement, also appear to be fully recourse as to the [redacted]. However, counsel for [redacted] disputes that the [redacted] are personally liable and claims that [redacted] insulates the [redacted] from liability. See response 23 in a letter dated [redacted] from [redacted]. We can only surmise whether the [redacted] would be held liable under applicable state law. In any event, the financing does not appear to be of the nonrecouse type as in Sanderson and Hilton, and the "Prudent Abandonment" Test is, thus, inapplicable., Fourth, the purchaser-lessor can compel a purchase at a formula price such as that discussed in Sanderson, or he can refuse the offer and continue to hold the property. Either action could result in a substantial profit. Further, save sales to public or quasi-public entities, we have found nothing in the lease that would prevent the sale or alienation of the property by the purchaser-lessor. Finally, further analysis may prove that upon payment of the "balloon" on the notes at the end of the primary term, the rent may result in a substantial cash flow.

We believe these factors justify litigation of the present case.

We realize that the facts of this case present litigation hazards. We would prefer that this case be consolidated with the purchaser-lessor's case and, as we informed you in a telephone conversation on June 11, 1986, steps are being taken to encourage the rapid issuance of a statutory notice of deficiency to the [redacted]. Should the [redacted] timely file a petition with the Tax Court, we suggest that you move to consolidate the cases for trial. However, if consolidation for trial is not possible, we believe the factors evidencing a valid sale-leaseback leave us no alternative but to recommend litigation of this case.

ROBERT P. RUWE

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